Office of Inspector General
U.S. Small Business Administration

May 2008 Update

Business Loan Programs

<u>OIG Issues Report on Oversight of SBA Supervised Lenders</u>. On May 9, 2007, the OIG issued an audit on Oversight of SBA Supervised Lenders. This is the second report from this audit. The first report focused on SBA's oversight of Business Loan Center. Based on the prior results, the scope of the audit was expanded to examine four other SBA-supervised lenders considered to present the highest levels of risk to the Agency. The overall objectives were to (1) determine whether SBA effectively addressed performance issues to mitigate the risk presented by these lenders and (2) identify opportunities that may exist to improve the oversight process.

The audit disclosed that, although SBA determined that the lenders reviewed posed a higher risk of financial loss than other 7(a) lenders, it did not take sufficient enforcement actions to mitigate the increased risk. Specifically, the four lenders were consistently rated as high-risk, had actual loan purchase rates exceeding those of other large lenders, were reported as having recurring performance and compliance issues during onsite examinations, and in the case of at least two of the lenders, consistently did not meet performance benchmarks established by SBA. As of September 2007, SBA had incurred a cumulative net loss from the four lenders of $329 million, and between September 2005 and September 2007 purchased over $239 million in guaranties from the lenders.

The audit also determined that SBA continued to renew and expand authorities delegated to lenders, allowing them to make loans without prior SBA approval. Although SBA met with lender management and reduced delegated lending authority periods when renewals were granted, it did not take progressively more stringent enforcement actions when lender performance did not improve or, in some cases, deteriorated. SBA did not take adequate risk mitigation measures because (1) there was a conflict between SBA's lender advocacy and oversight roles, which impacted SBA's treatment of lenders; (2) there was a lack of clear policies describing the circumstances under which enforcement actions would be taken; and (3) loan production goals made it difficult to maintain a proper balance between SBA's lender advocacy and oversight roles.

Finally, the audit identified weaknesses that further impacted SBA's supervision of the lenders, including untimely reviews of purchased loans at the National Guaranty Purchase Center (NGPC), timing of onsite examinations that did not coincide with delegated lending authority decisions and a limited scope of such examinations, inconsistent implementation of corrective action plans, and high risk loans identified by SBA's Loan and Lender Monitoring System (LLMS) that were not shared with lenders to effect corrective action.

To strengthen SBA's oversight of its supervised lenders, we made seven recommendations that addressed establishing oversight and enforcement criteria and risk mitigation goals, improvements to onsite examinations, the sharing of high risk loan information with lenders, and the staffing of the NGPC. The Agency agreed with five recommendations, partially agreed with one recommendation, and reported that it had already accomplished one recommendation.

<u>Company and Two Individuals Enter Settlement Agreement</u>. On April 17, 2008, an investment company and two individuals (hereafter called the defendants) entered into a settlement agreement with SBA and the Department of Justice (DOJ) based on their connection with a Small Business Investment Company (SBIC). They agreed to pay SBA and the Department of Justice (DOJ) $7,950,000 and

$2,000,000, respectively. A criminal investigation revealed that the defendants facilitated the creation of a technology company as an SBIC by knowingly assisting the manager of the SBIC and others to conceal material information from SBA. The defendants also knowingly helped the manager structure entities that he controlled so as to conceal relationships that violated SBA regulations. The OIG is conducting this investigation jointly with the Federal Bureau of Investigation (FBI).

Residential Property Owner Enters Guilty Plea. On May 1, 2008, a Virginia property owner entered a guilty plea to one count of mail fraud and one count of false oaths in a bankruptcy proceeding. He engaged in an extensive mortgage fraud scheme involving two residential properties that he owned. The properties were sold or refinanced despite the presence of a number of liens and judgments, including a judgment against him related to a defaulted SBA-guaranteed loan. Each time a property was sold or refinanced, he created bogus documents purporting to dismiss the encumbrances. He then diverted the loan proceeds for his personal use. The total loss to lending institutions was over $3.6 million. The property owner also made a false statement under oath in a bankruptcy proceeding concerning the sale of one of his properties. The OIG is conducting this investigation jointly with the FBI, the U.S. Postal Inspection Service, and the U.S. Secret Service.

Suspended Attorney Sentenced. On May 22, 2008, a suspended New Jersey attorney was sentenced to 30 months in jail, three years probation, restitution of $993,000 to be paid jointly and severally with other defendants, and a $200 special fee. Acting as a loan broker, the suspended attorney helped a businessman obtain an SBA-guaranteed loan through a small business lending company to supposedly purchase a supermarket owned by the businessman's mother. The suspended attorney knew that there was no sale of a business and, in exchange for a 10 percent fee, submitted false documents to the lending company to obtain the SBA loan. Specifically, he and the businessman provided forged power of attorney documents to improperly pledge collateral not belonging to the businessman and also falsified a $250,000 cash injection. Moreover, the loan proceeds were not used as designated. The suspended attorney also directed the owner of an accounting business to prepare a fraudulent tax record to make the businessman's company appear stronger than it actually was. The suspended attorney illegally received approximately $80,000 of his fee from the loan proceeds and laundered that fee by having it sent to the owner of the accounting business. The businessman has been sentenced and the owner of the accounting business is awaiting sentencing on separate charges. The OIG is conducting this joint investigation with the FBI.

Agency Management

OIG Issues Report on Planning for the Loan Management and Accounting System Modernization and Development Effort. On May 14, 2007, the OIG issued an audit on Planning for the Loan Management and Accounting System (LMAS) Modernization and Development Effort. The LMAS project, currently in the planning phase, was initiated in November 2005 to modernize SBA's mainframe-based Loan Accounting System (LAS) and make it independent from the mainframe, which is inflexible, presents security risks, and is based on obsolete technology. Our objectives were to assess the progress the Agency had made since project inception, the soundness of SBA's project management approach, and the adequacy of oversight activities established to review the conduct of and requirements for the planning effort, as well as to communicate areas of risk that need to be addressed as the LMAS project progresses.

The audit disclosed that, despite the urgency of addressing LAS security vulnerabilities, SBA was unable to replace the system prior to the expiration of the mainframe contract in February 2007, causing the Agency to renew costly contracts for mainframe and application support services for another 5 years. These services are expected to cost approximately $6 million per year. Also, by delaying its mainframe migration, SBA is not adhering to Federal guidance that requires timely remediation of information security risks. We also reported that SBA lacked both an enterprise-wide and project-level quality assurance function to ensure that LMAS adheres to quality standards, and an approved quality plan for the project that establishes the standards and procedures that will be employed to ensure adherence to requirements of the Office of the Chief Information Officer (CIO).

The report contained one recommendation addressed to the Associate Administrator for Capital Access, two recommendations addressed to the CIO, and two recommendations addressed to the LMAS project manager. SBA generally agreed to implement the first three recommendations, but did not provide a response regarding the recommendations addressed to the LMAS project manager.

This monthly update is produced by the SBA OIG, Eric M. Thorson, Inspector General.

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